DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0236
Adjusted Gross Income Tax
Tax Period 1999-2003

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax-Imposition of Tax on Construction Income

Authority: IC § 6-3-2-1; IC § 6-8.1-5-1(b); IC § 6-8.1-5-4.

The taxpayer protests the imposition of adjusted gross income tax on construction income.

II. Adjusted Gross Income Tax-Imposition of Tax on Unexplained Income

Authority: IC § 6-3-1-3.5(a); 26 U.S.C.A. § 62.

The taxpayer protests the imposition of adjusted gross income tax on unexplained income.

III. Adjusted Gross Income Tax-Disallowance of Expense Deductions

Authority: IC § 6-3-1-3.5; Webster's II New Riverside University Dictionary 81 1984.

The taxpayer protests the disallowance of several expense deductions.

IV. Tax Administration-Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

The taxpayer protests the imposition of the penalty.

Statement of Facts

The taxpayers are a married couple. After an investigation, the Indiana Department of Revenue (department) assessed additional adjusted gross income tax, penalty, and interest against them for the tax period 1999-2003. The taxpayers protested the assessment and a hearing was held. This Letter of Findings results.

I. Adjusted Gross Income Tax-Imposition of Tax on Construction Income

Discussion

The audit assessed adjusted gross income tax on the taxpayers' income from the husband's construction activities. The taxpayers argued that the husband did not operate a construction business since he did not charge for his services. Rather, he donated his construction services to others.

Notices of Proposed Assessment are prima facie evidence that the tax assessment is correct. IC § 6-8.1-5-1(b). The taxpayers bear the burden of proving that any assessment is incorrect. Id. Taxpayers are required to keep adequate books and records so that the department can determine the proper tax owed to the state. IC § 6-8.1-5-4.

An adjusted gross income tax is imposed upon the income of Indiana residents. IC § 6-3-2-1. If the husband never charged for his construction services, he would not have had any construction income on which to impose the tax. Court documents indicated that a dissatisfied customer had previously sued the taxpayer. In his defense of that lawsuit, the taxpayer submitted letters from satisfied customers stating that he had charged a fair price. The lawsuit and letters indicate that the husband actually operated a construction business and did not always donate his services.

The taxpayers' books and records were not adequate to allow the department to determine the correct amount of income earned in the husband's construction business. Therefore, the department had no option but to prepare an estimate based upon the best information available. The taxpayers did not produce adequate documentation to substantiate their contention that the department's estimate was inaccurate.

Finding

The taxpayer's protest to the assessment of tax on the construction income is denied.

II. Adjusted Gross Income Tax-Imposition of Tax on Unexplained Income

Discussion

The taxpayers had unexplained deposits in their bank accounts. The department assessed income tax on these deposits. The taxpayers protested this assessment contending that the deposits did not represent taxable income. Rather, the taxpayer argued that the deposits represented reimbursals of monies advanced for motivational tapes and seminar tickets.

Indiana adjusted gross income is calculated by starting with the federal adjusted gross income and making certain modifications. IC § 6-3-1-3.5(a). The federal adjusted gross income calculation begins with the inclusion of all of the taxpayers' income. 26 U.S.C.A. § 62.

The taxpayers offered no documentation to substantiate that the unexplained deposits into their bank accounts were anything other than income. Therefore, they failed to sustain their burden of proving that the unexplained deposits were not subject to the Indiana adjusted gross income tax.

Finding.

The taxpayers' protest to the assessment of Indiana adjusted gross income tax on unexplained deposits is denied.

III. Adjusted Gross Income Tax-Disallowance of Expense Deductions

Discussion

The taxpayers also operated a part-time business that involved two types of activities. First, the taxpayers sold items over the internet. Second, the taxpayers recruited and developed other sales people. The taxpayer took deductions for expenses incurred in the operation of the businesses. These deductions included mileage, internet usage, training and education, advertising and promotions, wages, supplies, postage, travel, meals, and lodging. Each year of the audit, the deductions exceeded the income the taxpayers received from this business. This resulted in losses that were taken against the taxpayers' income from the husband's construction business and wages received as a teacher. The department disallowed the deductions taken.

The Indiana adjusted gross income tax is calculated by starting with the taxpayers' federal adjusted gross income and making certain adjustments. IC § 6-3-1-3.5. Since the Indiana adjusted gross income tax is calculated by starting with the federal adjusted gross income, federal deductions are a part of the initial computation.

The taxpayers deducted the total cost of their internet usage claiming that it was used for business purposes only. There were six people in their household during the audit period. It is unknown if any of those people ever e-mailed a friend, checked the weather, or looked up a recipe on the internet. There were indications that the taxpayers ordered many of their goods for personal use over the internet. These are not business uses. The taxpayers were not entitled to deduct the entire amount of the internet charges. The taxpayers did not provide documentation of a reasonable estimate of the business use of the internet. They did not sustain their burden of proving that the internet usage was totally devoted to the business.

The taxpayers also took deductions for wages paid to their children. They provided no documentation substantiating that the payments to their children were actually wages for services rendered. The taxpayers did not sustain their burden of proving that the payments to their children were actually deductible wages.

The taxpayers claimed deductions for advertising expenses. Most of the advertising expenses claimed were gifts for family and friends ordered by the taxpayers through their internet sales business. Webster's II New Riverside University Dictionary 81 (1984) defines "advertise" as:

> 1. To make public announcement of, esp. to proclaim the qualities or advantages of so as to increase sale, *advertise* a new product.

Gifts to family and friend do not constitute public announcements about the qualities or advantages of a product. They do not have the effect of increasing sales. Therefore, gifts to family and friends do not qualify as advertising expenses. The taxpayers did not sustain their burden of proving that these gifts for family and friends were actually used for advertising. Therefore, these deductions cannot be taken against the taxpayers' income.

The taxpayers also claimed deductions for "tools" distributed to related dealers in the internet sales system. These tools were motivational tapes and books. The sales invoices they provided were postdated. The taxpayers did not substantiate *what* they paid for these items *even* if the expenses qualified as legitimate deductions.

The taxpayers took deductions for fees paid to attend seminars and the travel expenses associated with the seminars. The taxpayers submitted sheets of paper with handwritten statements of expenses on them and seminar programs to substantiate these deductions. There were no receipts or any other original documentation of a financial nature to substantiate their claims. The taxpayers did not sustain their burden of proving that they actually paid the amounts deducted for their travel, food, and seminars even if these expenses qualified as business deductions.

Finally, the taxpayers claimed deductions for office expenses and postage. Again, the taxpayers provided no original records substantiating their payments or whether the expenses they claimed were used for postage or office supplies.

Finding

The taxpayers' protest to the denial of the expenses taken as deductions on their federal adjusted gross income tax is denied.

IV. Tax Administration-Ten Percent Negligence Penalty

Discussion

The taxpayers protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayers did not keep the books and records necessary to determine the proper amount of tax due. Their disregard of their duty to keep accurate records constituted negligence.

Finding

The taxpayers' protest to the imposition of the penalty is denied.

KMA/JMM/DK/06/25/04